OPENING STATEMENT OF
RANKING DEMOCRATIC MEMBER PAUL E. KANJORSKI

SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE, AND GOVERNMENT SPONSORED ENTERPRISES

HEARING ON LEGISLATIVE SOLUTIONS FOR CREDIT RATING AGENCIES

WEDNESDAY, JUNE 29, 2005

Mr. Chairman, we return this morning to once again explore the issue of regulating credit rating agencies. As I have noted during our past hearings, entities like Standard and Poor's, Moody's, and Fitch have long published their views on the creditworthiness of the issuers of debt securities, and the significance of these opinions has greatly expanded in recent years.

Although rating agencies received some scrutiny after the recent surge of corporate scandals, we have not yet mandated any substantive changes in their practices. We have, however, since our last hearing begun to consider potential legislative reforms in this area. A bill, H.R. 2990, has been introduced by my colleague from Pennsylvania. In addition, at my request, the experts at the Securities and Exchange Commission have put together a conceptual legislative outline for our consideration.

While I agree with you, Mr. Chairman, that something needs to be done in this area of the securities marketplace to improve transparency and oversight, H.R. 2990 as introduced is not the solution to this problem. It would eliminate the current Nationally Recognized Statistical Rating Organization framework that we have had in place for three decades. Instead of casting this accepted framework aside, we should build on the work of the Commission in these matters.

H.R. 2990 is also, as one witness will note in her testimony today, "inconsistent with the overwhelming majority" of commenters in the most recent Commission concept release. As I understand, less than ten percent of the respondents to this concept release supported the elimination of the NRSRO framework.

Additionally, we now have a classic "quantity" versus "quality" debate. H.R. 2990 focuses on increasing the quantity of raters. To protect investors, we should focus on the quality of ratings as the Commission's conceptual legislative outline seeks to do.

In my view, the problems encountered by investors before Enron's downfall, WorldCom's bankruptcy, and New York City's debt crisis, among others, were related to the quality of ratings, not the quantity of raters. Nevertheless, Mr. Chairman, I understand the desire to increase competition in this field and I am willing to explore these matters further.

Additionally, in a statement prepared for today's hearing, the Bond Market Association notes that the bill "could ultimately dilute the important role credit rating agencies play in the capital markets." Mr. Chairman, I ask unanimous consent to insert this statement into the record.

Beyond quality issues, I am also concerned that H.R. 2990 could cause serious disruptions in the marketplace if enacted into law. Eliminating the recognition process and replacing it with a registration process could cause unintended consequences. The NRSRO concept, after all, has become embedded in many areas of the law. The term is used in about 8 federal statutes, 47 federal rules, and more than 100 state laws.

It is also used in laws related to communications, education, transportation, in addition to banking and securities statutes. Moreover, changing the phrase could cause uncertainty and

potential turmoil for any mutual fund that relies on a strategy of purchasing only those debt securities of investment grade, as determined by an NRSRO.

We must further be very sensitive to the First Amendment issues posed in these debates. The courts have previously ruled on matters such as the permissibility of registration requirements for publishers, which the NRSROs contend that they are. The courts have also ruled that we must be very precise in crafting statutes that impede upon the First Amendment. H.R. 2990 is vague in its present construction and needs work to withstand judicial scrutiny.

Ultimately, we need to move deliberately in these matters. From my perspective, we need to focus on the prior work of the Securities and Exchange Commission. We should also put a great deal of weight on their conceptual legislative outline as a roadmap for our work in the months ahead. The outline seeks to establish an effective supervisory system to ensure that credit rating agencies operate in a transparent manner with adequate policies and procedures.

To help us in these efforts, last week I called upon all interested parties to examine the roadmap of proposed reforms developed by the Commission's experts at my request, and I request unanimous consent to insert this document into the record. Today, I again call upon all parties to review this legislative outline and offer comments on it before the end of August.

In the meantime, I hope that the Commission and the rating agencies will expedite their deliberations over a voluntary agreement to improve transparency in the coming months. The success of these negotiations and the effectiveness in enforcing any final voluntary accord will help to determine the need for a compulsory bill and the speed of legislative action.

In conclusion, Mr. Chairman, this issue is one on which we should focus in the 109th Congress. I commend you for your leadership in these matters and hope that we can work together to identify an appropriate consensus in the months ahead.

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

THE CHAIRMAN

June 6, 2005

The Honorable Paul E. Kanjorski
Ranking Member
Subcommittee on Capital Markets, Insurance
and Government Sponsored Enterprises
U.S. House of Representatives
2188 Rayburn House Office Building
Washington, DC 20515

Dear Congressman Kanjorski:

I write in response to your April 12, 2005 letter, in which you request technical assistance in providing greater detail about the statutory authority the Commission may need if Congress determines that it is appropriate to create a comprehensive oversight regime for credit rating agencies.

In response to your request, I am enclosing an outline prepared by Commission staff that sets forth key authority issues that potentially would need to be addressed if Congress were to enact a legislative framework for the oversight and regulation of credit rating agencies. As you know, the Commission has not taken a formal position on the need for legislation.

Please let me know if we may be of further assistance.

Sincerely,

William H. Donaldson

Enclosure

STAFF OUTLINE OF KEY ISSUES FOR A LEGISLATIVE FRAMEWORK FOR THE OVERSIGHT AND REGULATION OF CREDIT RATING AGENCIES

I. Overview of Legislation. Credit rating agencies play an important role in the securities markets, but Congress has not expressly provided for any formal regulation of their activities. Longstanding concerns regarding the lack of a regulatory framework for credit rating agencies were heightened during the financial collapse of several large public companies. The purpose of any proposed legislation would be to provide the legal authority necessary to establish an effective oversight and examination regime to assure that credit rating agencies operate in a transparent manner, with adequate policies and procedures designed to ensure the credibility and reliability of the rating process, and full disclosure of, or restrictions on, conflicts of interest and anti-competitive practices.

To achieve these objectives, legislation could require nationally recognized statistical rating organizations ("NRSROs") and certain other credit rating agencies to register and become regulated by the Securities and Exchange Commission. The Commission, which has for several decades evaluated credit rating agencies through a staff no-action process, could be authorized to adopt substantive rules governing rating agency activities and would have examination, inspection, and enforcement authority. The Commission would *not* be expected to regulate the substantive decision-making of rating agencies or the content of the ratings they assign, issues that can best be addressed through the operation of a free and competitive marketplace.

II. Registration Requirements. Registration with the Commission typically is a key element in the Commission's oversight and regulation of securities market participants. Accordingly, a legislative approach could require certain credit rating agencies to register with the Commission. The Commission historically has been concerned primarily with those credit rating agencies that have the greatest market impact – those who by widespread dissemination of their ratings have become "nationally recognized." Accordingly, the legislation could require any credit rating agency that is designated as an NRSRO by the Commission (on its own motion or by application) to register with the Commission. For this purpose, an NRSRO could be defined, as recently proposed by the Commission, as a credit rating agency (i) that issues publicly available credit ratings that are current assessments of the creditworthiness of obligors with respect to specific securities or money market instruments and (ii) that is generally accepted in the financial markets as an issuer of credible and reliable securities ratings, including ratings for a particular industry or geographic segment, by the predominant users of securities ratings in the United States. In addition, the Commission could be given rulemaking authority to require a credit rating agency that does not meet the definition of NRSRO to register with the Commission and become subject to regulation, if the activities of the credit rating agency have a significant impact on the securities markets or pose a risk to investors, or otherwise as may be necessary or appropriate in the public interest.

III. Rulemaking Authority. Consistent with the Commission's statutory authority over other regulated entities, any legislation proposed could provide the Commission with broad authority to adopt rules in each of the key areas of concern. This approach may be preferable to trying to embed rigid prohibitions and requirements in statutory

language that could not be easily amended. Thus, the legislation could provide the Commission with authority to adopt rules in the following areas with respect to registered credit rating agencies:

- *Conflict of Interests.* The Commission could be given authority to adopt rules prohibiting or requiring the disclosure of conflicts of interest, such as conflicts arising from the payment scheme for credit ratings, financial arrangements with rated issuers, and relationships between the credit rating agency and the underwriter for securities issued by the rated issuer.

- *Competitive Issues.* The Commission could be given authority to adopt rules prohibiting or requiring the disclosure of potentially anticompetitive practices, such as tying arrangements, solicitation of payment for unsolicited ratings, and threats to modify ratings based on payment for related services.

- *Systematic Procedures Designed to Ensure Credible and Reliable Ratings.* To ensure the integrity of the ratings process, the legislation could require a credit rating agency registered with the Commission to adopt and implement systematic procedures designed to ensure credible and reliable ratings, in accordance with Commission rules. The legislation should not, however, regulate the substantive decision-making of rating agencies or the content of the ratings they assign.

- *Market Assessments of the Quality of Credit Ratings.* The legislation could authorize the Commission to adopt rules to define and establish minimum standards for determining whether a credit rating agency is generally accepted in the financial markets as an issuer of credible and reliable securities ratings. Market acceptance historically has been a crucial element in assessing whether a credit rating agency should qualify as an NRSRO or otherwise should be relied upon for regulatory purposes.

- *Misuse of Nonpublic Information.* The legislation could require a registered credit rating agency to adopt and implement written compliance policies and procedures designed to ensure compliance with the federal securities laws, manage conflicts of interest, and prevent the misuse of nonpublic information. In this regard, the Commission could be given authority to adopt rules requiring specific policies and procedures.

In addition to the specific rulemaking authority outlined above, the Commission could be given general rulemaking authority to carry out the purposes of the legislation and to classify persons, applications, reports, and other matters and prescribe greater, lesser, or different requirements for different classes. This general authority would permit the Commission to tailor its rules as may be appropriate in light of continuing cooperation with international regulatory bodies.

IV. Books and Records, Reporting, and Examinations. To the extent the Commission is granted rulemaking authority in the areas described above, it would be essential for the Commission to be able to enforce the substantive regulations through examination and

inspection tools, presumably modeled on the Securities Exchange Act of 1934 ("Exchange Act"). In this regard, the legislation could give the Commission authority to require a registered credit rating agency to make and keep such records, and make and disseminate such reports, as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of the Exchange Act. The Commission also could be given the authority to examine all records of a registered credit rating agency.

- *Non-Waiver of Privileges*. For an examination program to be effective, it is critical that the legislation permit a registered credit rating agency, as well as other regulated entities, to produce or disclose to the Commission any document or information that is subject to any Federal or State law privilege, or to the protection provided by the work product doctrine, without waiving the privilege or protection as to any other person. This provision would address a significant policy concern of regulated entities and greatly assist the Commission's examination program.

V. Enforcement Authority. Effective implementation of any regulatory framework would require that the Commission be granted administrative and civil enforcement authority comparable to that applicable to other entities registered under the Exchange Act. This would enable the Commission to bring an administrative action or civil injunctive action to enforce compliance by a registered credit rating agency, or any person associated with such credit rating agency, with the provisions of the Exchange Act and the rules thereunder, including those provisions specifically applicable to registered credit rating agencies.

VI. Statutory Framework. The legislation could be incorporated into the Exchange Act. If so, the general provisions in that Act, including those relating to investigations, enforcement procedures, exemptive authority, and general rulemaking authority, would apply to the regulation of registered credit rating agencies, with such conforming changes as may be appropriate.